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SUBJECT: Trade with Russia Falls under New VAT Rules

Refs: (A) Minsk 171, (B) Minsk 174, (C) Minsk 247

¶1. Summary: In January Belarus and Russia switched the way VAT on bilateral trade is paid. President Lukashenko and other GOB officials constantly state this change benefited Belarus, and bilateral trade has increased. However, the GOB's own statistics show a 8.9 percent drop in commerce with Belarus' main trading partner. Anecdotal evidence also points to bilateral trade being sharply affected. Additionally, a leaked government memo highlights the damage this has done to local industry, and concludes this switch hurt Belarus' economy. Meanwhile, Lukashenko has issued several temporary decrees to mollify Belarus' small entrepreneurs, who protested the VAT change last spring. Still, the seeds for further protest by this group have been planted. End summary.

¶2. On January 1 Belarus and Russia switched their mechanism for collecting VAT on bilateral trade from the country of origin to the country of destination principle. The GOB originally anticipated earning an additional USD 200 million in taxes annually from this move. On September 19, Deputy Finance Minister Ivan Shunko announced the GOB may even earn an additional USD 300 million from VAT in 2005. Because of the way this policy change was implemented, and the lack of preparation in both countries, bilateral trade dropped sharply in January (ref A). GOB officials have repeatedly stated that VAT restructuring has not resulted in any problems and that trade with Russia is booming. In February the Ministry of Statistics even announced that Belarusian foreign trade (roughly half of which is with Russia) increased 37 percent in January.

¶3. However, recently released trade statistics for the first half of 2005, anecdotal evidence, and a leaked government memo all lead to the conclusion that January's restructuring of VAT has had a large, continuing and negative impact on Belarus' trade with Russia.

The Statistics -----

¶4. According to the MFA, trade between Belarus and Russia for the first half of 2005 fell by 8.9 percent, to USD 6.9 billion, compared to the same period in 2004. Belarus' exports to Russia fell by 8.7 percent, to USD 2.656 billion, and its imports from Russia fell by 9.1 percent, to USD 4.289 billion. Russia accounts for 36 percent of Belarus' exports and 60.5 percent of its imports. Belarus' main exports to Russia include tractors, trucks, metals, tires, household appliances, and foodstuffs. Belarus imports from Russia oil, natural gas, electricity, coal, ferrous metals,

engines, metal working machinery and chemicals.

15. Despite these official statistics, GOB officials continue to assert everything is fine. Prime Minister Sidorsky announced September 6 at the opening of the first Belarus-Russia Economic Forum that Belarus' trade with Russia increased by five percent in the first half of 2005. President Lukashenko at the same event stressed at length the strength and growth of Belarusian-Russian trade. However, Russian Prime Minister Fradkov replied in his address that he hopes bilateral trade levels for 2005 do not drop too far, "after many problems, such as VAT redirection." Two Russian officials, First Deputy Mayor of Moscow Yury Roslyak and Aleksey Kaulbars, a department head at the Ministry of Economic Development, both stated at the forum the drop in bilateral trade is the result of difficulties arising from the new VAT structure.

Everything is Good, But...

16. In July Lukashenko admitted, "There was a big VAT problem early this year, now there is almost no problem." He went on to claim that tax revenues are up by BYR 800 million [USD 372,000] for the year and that the new VAT scheme led many companies to increase their profits, some by 50 percent. Despite Lukashenko's claims, several businesses have reported otherwise to Emboffs. The owner of a Vitebsk brick factory said he lost all his trade to Russia because of the new VAT mechanism, and had to close half his factory. He said this was typical in Vitebsk. Officials at the Minsk Automobile Factory, Belarus' fourth largest company, admitted sales to Russia fell in 2005. According to the Ministry of Statistics (MoS), truck sales to Russia fell 8.7 percent and the import of Russian cars fell 6.2 percent in the first half of 2005.

17. According to the MoS, the new VAT scheme increased taxes paid to the state, up 100 percent from the year before to BYR 2.286 trillion [USD 1.063 billion] in the first half of the year. VAT on goods imported from Russia accounted for roughly 40 percent of that amount, BYR 457 billion [USD 213 million]. The GOB insists it lost an estimated USD 200 million a year to Russia under the old VAT scheme, and is demanding the GOR pay USD 1.2 billion in restitution as a precondition to any currency union.

But Some Say it is Bad for Belarus

18. Despite the increase in tax revenue, in an internal GOB memo leaked to the press in August, Presidential Aide Sergey Tkachev argued this change was actually harmful to the Belarusian economy. He wrote that Russian suppliers of raw materials are not deducting the previous amount of Russian VAT from the cost of goods exported to Belarus, so Belarusian firms are paying last year's prices for imports (with the previous amount of Russian VAT now going to the Russian company) as well as an 18 percent Belarusian VAT. In one example, the GOB insisted earlier in the year that Gazprom reduce the price of natural gas by 18 percent (from last year's rate of USD 46.68/thousand cubic meters) to compensate for a change in the VAT mechanism. Gazprom refused, and continues to charge USD 46.68. Even though Beltransgaz is a state company, it still has to pay VAT on gas imports, effectively raising the price of gas by 18 percent as of January 1.

19. Tkachev also argued the apparent rise in VAT revenues is a mirage. When Belarusian exporters ship goods to Russia, they have to supply the GOB with proof VAT is paid on those goods in Russia. Business contacts tell Emboffs in many cases obtaining such proof is impossible. When no paper work is available, the Belarusian exporter must pay VAT to the GOB, plus a large fine. Even when paperwork is available, in many cases the Belarusian firm has to pay VAT to the GOB on goods it exports. Once the company submits the paperwork proving VAT was paid in Russia, the GOB should reimburse that VAT. Tkachev wrote that the GOB owes Belarusian exporters BYR 465.5 billion [USD 217 million] in overdue VAT reimbursement from the first half of 2005. This accounts for 20 percent of taxes collected during that period. Further, he argued that Belarusian exporters face liquidity problems because the GOB has not reimbursed them for paid VAT, forcing them to seek loans to compensate or be delinquent in paying other bills. Valery

Dashkevich, an economist at BelGazpromBank, told us because the GOB has not been reimbursing exporters for VAT paid in Russia, most major Belarusian exporters have stopped paying VAT to the GOB, arguing their current taxes are offset by what the GOB owes. This is likely to lead to sharply reduced tax revenues in the second half of 2005.

¶10. Tkachev concluded, "Our revenues have shrunk, we get dearer Russian raw materials, the prices for which have risen - maybe not by the value of the VAT, but by a significant share. We should also think about to whom to sell, to go through the complex method of confirming, returning and offsetting VAT. It all causes a growing inventory of finished stock... . The Union State has lost much." Ivan Ivanov, head of the local International Finance Corporation office, agreed with Tkachev's assessment, "I do not think the new mechanism is more profitable for Belarus. It was easier to trade with Russia, the main trading partner, before."

Not all Bad

¶11. Even though trade with Russia fell, some analysts state the problems with VAT forced Belarusian companies to divert their trade away from Russia. According to the MFA, trade with Ukraine rose 65 percent in the first seven months of the year, largely based on increased sales of Belarusian agricultural equipment, televisions, refrigerators, glass, potash and oil to Ukraine. According to the IMF, exports to western countries also surged. As a result, Belarusian exports as a whole rose 19.6 percent, to USD 7.4 billion.

Entrepreneurs Satisfied, for Now

¶12. Belarusian entrepreneurs protested the new VAT rules in February and March (refs B and C). In response, Lukashenko exempted individual entrepreneurs from paying the new VAT for six months. On August 1 the GOB implemented a temporary rule, valid until December 1, allowing business owners to pay a fixed rate for VAT if no documents accompany the imported goods. [Note: Thousands of Belarusian small businesses import small amounts of goods from Russia for resale, often in kiosks. Because of the nature of this shuttle trade, and the customs free border with Russia, accompanying documents are usually impossible to obtain.] The fixed rate ranges from USD 230 to 325 per month, depending on the type of business and its location. Perspektiva, an NGO that works with small businesses and which organized the February and March protests, believes this VAT will force many small businesses into bankruptcy. Small scale traders will have to raise their prices 10 to 50 percent, based on their volume of sales, and will not be able to compete with wholesale importers who pay the same rate but deal in much larger volumes. However, these moves by the GOB have apparently diffused the earlier anger of many entrepreneurs, which led to last spring's protests.

Comment

¶13. The GOB appeared to rush into the decision to change the way VAT on trade with Russia is paid, focusing solely on the perceived increase in taxes, and not thinking about repercussions on industry. [Note: One official told Econoff the decision was only made in September 2004, three months before the change was implemented, with details worked out afterwards.] While some businesses have managed to redirect their exports, others have seen a sharp drop in sales and had to reduce their production. Despite GOB claims of constant growth and success (part of Lukashenko's endless propaganda that all is well in his Belarus), many appear to have been hurt by this move. The entrepreneurs are quiet now, but that could change as businesses collapse or the GOB's temporary mollifying measures expire.

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